



Decision to exclude Petr leo Brasileiro S.A. (Petrobras)

1 June 2016

1. Summary

KLP and the KLP funds (hereafter, "KLP") have decided to exclude the company Petr leo Brasileiro S.A. (hereafter, "Petrobras") from their investments. KLP had investments in Petrobras of approximately 33,74 million NOK as of 11 April 2016.

Petrobras is currently embroiled in the largest corruption case in Brazilian history.¹ Over nearly a decade, the company's contracts with suppliers were regularly inflated by three percent of the contract sum, with the excess paid to Brazilian politicians, political parties and senior Petrobras management.² In response to the scandal, Petrobras developed a new and far more comprehensive anti-corruption program. Senior managers and board members have departed, including the CEO, CFO,³ and board chairman.

KLP nevertheless assesses the risk that Petrobras will be involved in serious corruption in the future to be unacceptably high for four reasons:

- 1) The scale and duration of the scheme uncovered that corruption at Petrobras was both **serious and systematic** and could not have occurred without the involvement of employees and managers at various levels throughout the company. Petrobras estimated the amount lost to

¹ "Corruption in Brazil: the big oily", *The Economist* (3 January 2015). URL:

<http://www.economist.com/news/americas/21637437-petrobras-scandal-explained-big-oily>.

² Petrobras calculated the amount lost to corruption as three percent of contracts with the 27 suppliers under investigation as members of the cartel, between 2004 and 2012. Petrobras, *Operation Lava Jato*, <http://lavajato.hotsitespetrobras.com.br/en/>.

³ Valle, Sabrina, Denyse Godoy, and Paula Sambo, "Petrobras executive exodus clouds emergence from graft case", *Bloomberg* (4 February 2015). URL: <http://www.bloomberg.com/news/articles/2015-02-04/petrobras-says-ceo-resigned>.

corruption at approximately 2.06 billion USD.⁴ Brazilian prosecutors believe the real figure is closer to 5 billion USD.⁵

- 2) The company's **governance structure** limits the influence of minority shareholders to effect change. The Brazilian state appoints a majority of directors as well as top executives at Petrobras.⁶ At the same time, the corruption scheme has resulted in the arrest, and in some cases, conviction of politicians connected to the ruling party and several opposition parties.
- 3) **Petrobras maintains that the company is a victim of corruption.** A company acts through its representatives, and senior Petrobras executives have been convicted for their role in the corruption scheme. The scale and scope of corruption uncovered at Petrobras indicate that employees at various levels of the company either participated in the scheme or willfully ignored evidence that suggested something was amiss. Petrobras also did not implement a comprehensive anti-corruption program before 2013.
- 4) Petrobras **does not appear to have undertaken any more systematic analysis of corruption risk in its global operations.** Given the systematic nature of the corruption scheme uncovered, as well as Petrobras' operations in high-risk markets such as Angola, Nigeria, and Venezuela, it is imprudent to limit the focus of internal investigations to Brazil.

For these reasons, KLP has determined the risk of future corruption to be unacceptably high and has therefore excluded Petrobras from KLP and the KLP funds' investments.

2. Introduction

Petrobras is a vertically integrated oil and gas company with operations in over 19 countries.⁷ The company is based in Brazil and is listed in that country, as well as in the United States, Spain, and Argentina.⁸ The Brazilian state is the controlling shareholder in Petrobras.⁹ The Brazilian state holds a majority of the voting shares in Petrobras and has routinely appointed politicians to key posts at the company.

⁴ Leahy, Joe and Samantha Pearson, "Brazil's Petrobras takes \$17bn hit", *Financial Times* (23 April 2015). URL: <http://www.ft.com/intl/cms/s/0/d6be40d0-e952-11e4-a71a-00144feab7de.html>.

⁵ Stauffer, Caroline, "Petrobras likely lost more than \$5bln to corruption: Brazilian prosecutor", *Reuters* (9 October 2015). URL: <http://www.reuters.com/article/us-brazil-corruption-petrobras-idUSKCN0S32CA20151009>.

⁶ Leahy, Joe, "What is the Petrobras scandal that is engulfing Brazil?", *Financial Times* (31 March 2016). URL: <http://www.ft.com/intl/cms/s/2/6e8b0e28-f728-11e5-803c-d27c7117d132.html>.

⁷ Petrobras, "Global Presence", *About Us*. URL: <http://www.petrobras.com/en/about-us/global-presence/> (last visited 22 March 2016). In addition to its main operations in Brazil, Petrobras is active the United States, Colombia, Venezuela, Bolivia, Paraguay, Chile, Uruguay, Argentina, the United Kingdom, the Netherlands, Nigeria, Gabon, Angola, Tanzania, Singapore, China, and Japan. Petrobras, "Global Presence", *About Us*. URL: <http://www.petrobras.com/en/about-us/global-presence/> (last visited 22 March 2016).

⁸ Petrobras, "Corporate Governance", *Investor Relations*. URL: <http://www.investidorpetrobras.com.br/en/corporate-governance/corporate-governance> (last visited 22 March 2016).

⁹ Petrobras, "Capital Ownership Composition", *Investor Relations*, URL: <http://www.investidorpetrobras.com.br/en/corporate-governance/capital-ownership> (last visited 22 March 2016).

In addition to its operations in Brazil, Petrobras also operates in several countries that are among those ranked lowest on the Transparency International Corruption Perception Index, including, for example, Angola, (163), Venezuela (158), Nigeria (136).¹⁰

3. Case description and the company's involvement

The Brazilian police began uncovering corruption involving Petrobras in 2014, through an investigation known as "Operation Car Wash."¹¹ Paulo Roberto Costa, a senior executive at Petrobras under investigation for money laundering, admitted to police that he accepted bribes from a cartel of Petrobras suppliers over nearly a decade.¹² Costa's revelations touched off a widespread investigation into bribes to Petrobras executives, Brazilian political parties, and even leading Brazilian politicians.¹³

The scale of the corruption uncovered thus far is unprecedented. As of April 2016, Brazilian prosecutors have charged 179 individuals with criminal offenses in connection with the Petrobras case, with 93 convictions thus far.¹⁴ Under Brazilian law, investigations of sitting elected officials fall under the jurisdiction of the Supreme Court, which ordinarily takes longer to process cases than the lower courts.¹⁵ Nevertheless, the former Senate leader for the governing party has agreed to a plea bargain in which he implicates the former president, various ministers, members of parliament and judges, as well as senior Petrobras officials.¹⁶ Dozens of former Brazilian lawmakers have been convicted in the lower courts for their involvement in the corruption scheme.¹⁷ Approximately 57 politicians or former politicians were under investigation already in March 2015.¹⁸

Convicted officials with key positions at Petrobras include two former directors of the international division,¹⁹ the director of refining and supply (Costa),²⁰ two former directors of services,²¹ as well as

¹⁰ Petrobras, *Global presence*, <http://www.petrobras.com/en/about-us/global-presence/> (last visited 11 April 2016); and Transparency International, *Corruption Perceptions Index 2015*, <http://www.transparency.org/cpi2015>.

¹¹ Connors, Will and Luciana Magalhaes, "How Brazil's 'Nine Horsemen' Cracked a Bribery Scandal", *The Wall Street Journal* (6 April 2015). URL: <http://www.wsj.com/articles/how-brazils-nine-horsemen-cracked-petrobras-bribery-scandal-1428334221>.

¹² Ibid.

¹³ Ibid.

¹⁴ Leahy, Joe, "What is the Petrobras scandal that is engulfing Brazil?", *Financial Times* (31 March 2016). URL: <http://www.ft.com/intl/cms/s/2/6e8b0e28-f728-11e5-803c-d27c7117d132.html>.

¹⁵ Jelmayer, Rogerio, "Brazil's Car Wash investigation sends evidence to the Supreme Court", *The Wall Street Journal* (28 March 2016). URL: <http://www.wsj.com/articles/brazils-car-wash-investigation-sends-evidence-to-supreme-court-1459203245>.

¹⁶ Associated Press, *Daily Mail* (15 March 2016). URL: <http://www.dailymail.co.uk/wires/ap/article-3493417/Critics-blast-rumors-Brazil-ex-Pres-Silva-named-minister.html>.

¹⁷ Simoes, Eduardo, "Brazil senator, top banker charged with blocking Petrobras probe", *Reuters* (7 December 2015). URL: <http://www.reuters.com/article/us-brazil-corruption-charges-idUSKBN0TQ2RV20151208>.

¹⁸ Watts, Jonathan, "Brazil: hundreds of thousands of protestors call for Rousseff impeachment", *The Guardian* (15 March 2015). URL: <http://www.theguardian.com/world/2015/mar/15/brazil-protesters-rousseff-impeachment-petrobras>.

¹⁹ Reuters, "Former Petrobras executive sentenced over alleged congressional bribe", *The Guardian* (17 August 2015). URL: <http://www.theguardian.com/world/2015/aug/17/former-petrobras-executive-nessor-cervero-sentenced-bribe>; Stauffer, Caroline, "Former Petrobras exec sentenced over Vantage Drilling contract", *Reuters* (1 February 2016). URL: <http://www.reuters.com/article/brazil-corruption-petrobras-idUSL2N15G1SH>.

²⁰ MercoPress, "Brazilian construction tycoon sentenced to 19 years in prison for Petrobras corruption scandal", *MercoPress*, <http://en.mercopress.com/2015/11/04/brazilian-construction-tycoon-sentenced-to-19-years-in-prison-for-petrobras-corruption-scandal>.

²¹ BBC News, "Former Brazil Workers' Party treasurer sentenced for corruption", *BBC News* (22 September 2015). URL: <http://www.bbc.com/news/world-latin-america-34318633>; Sandy, Matt, "How the Petrobras

other executives.²² According to investigations by the Council on Ethics for the Norwegian Government Pension Fund, which included an analysis of court documents available in Portuguese, at least 11 top executives and middle managers had been charged in connection with the corruption scheme as of December 2015.²³

In 2014, Petrobras' auditor PwC refused to sign off on the company's third quarter results.²⁴ Petrobras published its audited Q3 results five months later, in a last-minute effort to avoid defaulting on its loan covenants.²⁵ In its audited financial statements, Petrobras estimated the amount lost to corruption through bribes at approximately 2.06 billion USD.²⁶ Brazilian prosecutors believe the true loss is closer to 5 billion USD.²⁷

In a statement on its website, Petrobras acknowledges that the company is currently under investigation by Brazilian authorities and the US Department of Justice.²⁸ Moreover, the company states that several top executives at Petrobras are under investigation or have been convicted for their role in the corruption scheme:

*As an outcome of the aforementioned Operation, a former Petrobras director was convicted by a trial court on April 22 for money laundering and criminal organization. Another two Petrobras former directors and one executive manager have been indicted for these same crimes, in addition to passive bribery. Executives from companies supplying goods and services to Petrobras have also been jailed as a result of the investigation.*²⁹

In March 2016, the Petrobras investigation unearthed a list of 200 politicians alleged to have received bribes from Petrobras supplier Odebrecht.³⁰ In addition, the recently released Panama Papers identified 57 individuals and companies connected to the Petrobras corruption scheme among beneficial owners of shell companies in secrecy jurisdictions.³¹ These developments suggest the scale of the investigation may widen in the future.

The ripple effects from the investigation reach beyond Brazil. According to Brazilian prosecutors, over 285 foreign companies worked with agents that are under investigation in connection with the Petrobras

scandal ensnared Lula – and upturned Brazilian politics", *Time* (16 March 2016). URL: <http://time.com/4261712/lula-brazil-petrobras-scandal/>.

²² Stauffer, Caroline, "Former Petrobras exec sentenced over Vantage Drilling contract", *Reuters* (1 February 2016).

²³ Council on Ethics for the Norwegian Government Pension Fund – Global, *Recommendation 21 December 2015 to place Petroleo Brasileiro SA under observation* (21 December 2015), p. 5. URL:

<http://etikkradet.no/en/recommendation-21-december-2015-to-place-petroleo-brasileiro-sa-under-observation/>.

²⁴ Brandimarte, Walter and Marta Nogueira, "Auditor refuses to sign off Brazil Petrobras' Q3 results", *Reuters* (1 November 2014).

²⁵ Leahy, Joe and Samantha Pearson, "Brazil's Petrobras takes \$17bn hit", *Financial Times* (23 April 2015). URL: <http://www.ft.com/intl/cms/s/0/d6be40d0-e952-11e4-a71a-00144feab7de.html>.

²⁶ Ibid.

²⁷ Stauffer, Caroline, "Petrobras likely lost more than \$5bln to corruption: Brazilian prosecutor", *Reuters* (9 October 2015). URL: <http://www.reuters.com/article/us-brazil-corruption-petrobras-idUSKCN0S32CA20151009>.

²⁸ Petrobras, *Operation Lava Jato*. URL: <http://lavajato.hotsitespetrobras.com.br/en/> (last visited 8 April 2016).

²⁹ Ibid.

³⁰ Leahy, Joe, "Brazil's tainted elite leaves few alternatives to Rousseff", *Financial Times* (25 March 2016). URL: <http://www.ft.com/intl/cms/s/0/8d39a416-f222-11e5-a609-e9f2438ee05b.html>.

³¹ Watkinson, William, "Panama papers: 57 people linked to Brazil's Petrobras scandal also feature in Mossack Fonseca leak", *International Business Times* (6 April 2016). URL: <http://www.ibtimes.co.uk/panama-papers-57-people-linked-brazils-petrobras-scandal-also-feature-mossack-fonseca-leak-1553347>.

scandal.³² The head of Brazil's largest construction firm was recently sentenced to 19 years in prison³³ and the head of Latin America's largest investment bank is under investigation for alleged obstruction of justice in connection with the Petrobras scheme.³⁴

4. Company response

A. Governance

The Brazilian state holds 60% of the voting shares in Petrobras and has routinely appointed politicians to key posts at the company.³⁵ The state appoints seven of the ten Petrobras board members.³⁶ News reports detail an intertwined relationship between the Brazilian state, Brazilian political parties, and Petrobras executives.³⁷ For example, members of the ruling party appointed Paulo Roberto Costa, who ultimately provided the details that broke the investigation open.³⁸

The CEO and CFO of Petrobras resigned in February 2015, along with the chief of refining, gas, and engineering.³⁹ The Petrobras board appointed the head of Brazil's largest bank, Banco do Brasil to replace her.⁴⁰ Banco do Brasil has provided extensive financing both to Petrobras and many of the suppliers implicated in the corruption scheme, and the new CEO is reportedly closely linked to the governing party and the until recent president.⁴¹

The Petrobras board chairman resigned in March 2015. Like his more recent predecessors, Guido Mantega was a formerly high-ranking government official: the former finance minister.⁴² At the Petrobras annual general meeting in 2015, the CEO of Brazilian mining company Vale replaced the

³² Stauffer, Caroline, "Former Petrobras exec sentenced over Vantage Drilling contract", *Reuters* (1 February 2016).

³³ Pearson, Samantha, "Petrobras scandal claims Marcelo Odebrecht, its biggest name yet", *Financial Times* (11 March 2016). URL: <http://www.ft.com/intl/cms/s/0/0074dda0-e775-11e5-bc31-138df2ae9ee6.html> (last visited 12 April 2016).

³⁴ Schmidt, Blake, Maria Luiza Rubello, and Francisco Marcelino, "BTG Pactual tanks as Petrobras probe leads to chairman's arrest", *Bloomberg* (25 November 2015). URL: <http://www.bloomberg.com/news/articles/2015-11-25/btg-s-andre-esteves-senator-amaral-arrested-brazil-police-say> (last visited 12 April 2016).

³⁵ Segal, David, "Petrobras oil scandal leaves Brazilians lamenting a lost dream", *New York Times* (7 August 2015). URL: http://www.nytimes.com/2015/08/09/business/international/effects-of-petrobras-scandal-leave-brazilians-lamenting-a-lost-dream.html?_r=0 (last visited 12 April 2016).

³⁶ Kiernan, Paul, "Brazil's Petrobras confirms new board members", *The Wall Street Journal* (30 April 2015). URL: <http://www.wsj.com/articles/brazils-petrobras-confirms-new-board-members-1430394100> (last visited 12 April 2016).

³⁷ Segal, David, "Petrobras oil scandal leaves Brazilians lamenting a lost dream", *New York Times* (7 August 2015). URL: http://www.nytimes.com/2015/08/09/business/international/effects-of-petrobras-scandal-leave-brazilians-lamenting-a-lost-dream.html?_r=0 (last visited 12 April 2016).

³⁸ *Ibid.*

³⁹ Valle, Sabrina, Denyse Godoy, and Paula Sambo, "Petrobras executive exodus clouds emergence from graft case", *Bloomberg* (4 February 2015). URL: <http://www.bloomberg.com/news/articles/2015-02-04/petrobras-says-ceo-resigned> (last visited 8 April 2016).

⁴⁰ Leahy, Joe, "Petrobras shares fall after Aldemar Bendine named new CEO", *Financial Times* (7 November 2015). URL: <http://www.ft.com/intl/cms/s/0/9891aaa4-ae06-11e4-919e-00144feab7de.html> (last visited 12 April 2016).

⁴¹ *Ibid.*

⁴² Eisenhammer, Stephen, "Petrobras names BNDES head, Coutinho as new chairman", *Reuters* (26 March 2015). URL: <http://www.reuters.com/article/petrobras-chairman-idUSL2N0WS2VC20150326> (last visited 12 April 2016).

interim board chairperson.⁴³ For the first time in recent years, the board no longer includes any high-ranking members of the Brazilian government, after the Brazilian state removed the name of an incumbent former general from the slate of candidates.⁴⁴ The new board chairman resigned in December 2015, however, and was replaced with an interim chair who is up for election at the 2016 Petrobras annual general meeting.⁴⁵

B. Direct measures in response to investigation

Petrobras states that it is cooperating fully with the relevant authorities in the ongoing investigations in Brazil and the United States.⁴⁶ The company has hired both a Brazilian and a US law firm to conduct internal investigations.⁴⁷ Petrobras was not aware of whether the investigations will extend beyond the immediate corruption scheme in Brazil, as the law firms' mandates derive from a Special Committee whose communications with the law firms are confidential.⁴⁸

The Special Committee includes the Petrobras Compliance Director, as well as external anti-corruption experts.⁴⁹ According to Petrobras, all of the Special Committee's conclusions on policies and procedures must be implemented within the company.⁵⁰ It is unclear when the investigation will be complete and Petrobras could not comment on whether the reports would be made public.⁵¹

Petrobras has barred suppliers named as members of the cartel from participating in any new contract bids.⁵² Nevertheless, the company continues to honor existing contracts with these suppliers.⁵³ Since 2013, Petrobras has included standard language in supplier contracts regarding anti-corruption.⁵⁴ The company could not confirm, however, what proportion of all outstanding contracts include anti-corruption clauses.⁵⁵ Since October 2015, Petrobras requires two employee signatures on all supplier contracts, as an extra check.⁵⁶

Petrobras maintains a registry of approved suppliers, which Petrobras subsidiaries are encouraged, but not required, to use.⁵⁷ In general, subsidiaries are required to submit their procurement policies and procedures to Petrobras for approval, but responsibility for implementation remains with the subsidiaries.⁵⁸

KLP was unable to locate information on the number of employees Petrobras has disciplined in connection with the corruption scheme. Rather, in December 2015, Petrobras reported the *total*

⁴³ Kiernan, Paul, "Brazil's Petrobras confirms new board members", *The Wall Street Journal* (30 April 2015). URL: <http://www.wsj.com/articles/brazils-petrobras-confirms-new-board-members-1430394100> (last visited 12 April 2016).

⁴⁴ Ibid.

⁴⁵ Valle, Sabrina and Carlos Caminada, "Petrobras dream team splits on approach to turnaround", *Bloomberg* (30 November 2015). URL: <http://www.bloomberg.com/news/articles/2015-11-30/petrobras-chairman-murilo-ferreira-resigns-from-board> (last visited 12 April 2016).

⁴⁶ Petrobras, *Operation Lava Jato*. URL: <http://lavajato.hotsitespetrobras.com.br/en/> (last visited 8 April 2016).

⁴⁷ Ibid.

⁴⁸ Call notes on file with KLP.

⁴⁹ Ibid.

⁵⁰ Ibid.

⁵¹ Ibid.

⁵² Petrobras, *Operation Lava Jato*. URL: <http://lavajato.hotsitespetrobras.com.br/en/> (last visited 8 April 2016).

⁵³ Ibid.

⁵⁴ Call notes on file with KLP.

⁵⁵ Ibid.

⁵⁶ Ibid.

⁵⁷ Ibid.

⁵⁸ Ibid.

number of disciplinary measures for "misconduct and harassment, damage to property, fraud, theft, negligence, and for the improper use of our resources."⁵⁹ In other words, these are not limited to the corruption investigation. According to Petrobras, 17 employment contracts have been terminated and 61 employees have been suspended for up to 29 days. An additional 94 employees have received written warnings.⁶⁰

C. Anti-corruption program

In 2013, the Petrobras board approved a new anti-corruption program, which includes several new structures to handle corruption allegations.⁶¹ First, Petrobras established an internal investigation committee to evaluate allegations of corruption and fraud.⁶² In addition, Petrobras established an ombudsman to receive complaints. The ombudsman reports directly to the board. Petrobras also established an independent and anonymous whistleblower channel in November 2015 that is available to suppliers, customers, and other third parties in all countries in which Petrobras has operations.⁶³ An outside company operates the whistleblower channel and reports results to the Petrobras compliance department.⁶⁴

During 2015, Petrobras trained approximately 3,000 employees in anti-corruption measures, primarily through an e-learning program, as well as limited in-person training for the board of directors and key executives.⁶⁵ Petrobras confirmed to KLP that the e-learning program consists of the UN Global Compact video series "The Fight Against Corruption: E-Learning Tool" from 2010.⁶⁶ The series is informative and highlights corruption risks in general, but is not in any way specific to Petrobras. The company intends to train 100% of Petrobras employees in this program by the end of 2016.⁶⁷ Petrobras is developing a tailored training module for employees in particularly exposed roles, but does not have any immediate plans to develop an e-learning training module for all employees that would be specific to Petrobras.⁶⁸ The company currently asks employees to read and sign the Petrobras code of conduct.⁶⁹

In November 2014, the Petrobras board also established a new position of Chief Governance, Risk and Compliance Officer.⁷⁰ The new Directorship of Governance, Risk and Compliance is expected to have approximately 360 employees. Petrobras had filled a majority of these positions by April 2016, all through internal hires.⁷¹ Petrobras obtained background checks on each of them.⁷²

One deficiency in the Petrobras anti-corruption program is that it does not explicitly prohibit facilitation payments. When asked about this omission, the company explained that facilitation

⁵⁹ Petrobras, "Executives take stock of our actions to combat fraud and corruption", *Petrobras Magazine*, edn 65. URL: <http://www.petrobras.com/en/magazine/post/executives-take-stock-of-our-actions-to-combat-fraud-and-corruption.htm> (last visited 11 April 2016).

⁶⁰ Ibid.

⁶¹ Petrobras, *Petrobras Corruption Prevention Program: Manual*, s. 3. URL: <http://www.petrobras.com.br/lumis/portal/file/fileDownload.jsp?fileId=8A10550E494F5580014A2EC0AEAA16B4>.

⁶² Ibid, s. 11..

⁶³ Petrobras, *Operation Lava Jato*. URL: <http://lavajato.hotsitespetrobras.com.br/en/> (last visited 8 April 2016).

⁶⁴ Call notes on file with KLP.

⁶⁵ Petrobras, *Operation Lava Jato*. URL: <http://lavajato.hotsitespetrobras.com.br/en/> (last visited 8 April 2016).

⁶⁶ UN Global Compact, *The Fight Against Corruption: E-Learning Tool* (2010), <http://thefightagainstcorruption.org/certificate/>.

⁶⁷ Petrobras, *Operation Lava Jato*. URL: <http://lavajato.hotsitespetrobras.com.br/en/> (last visited 8 April 2016).

⁶⁸ Call notes on file with KLP.

⁶⁹ Ibid.

⁷⁰ Petrobras, *Operation Lava Jato*. URL: <http://lavajato.hotsitespetrobras.com.br/en/> (last visited 8 April 2016).

⁷¹ Call notes on file with KLP.

⁷² Ibid.

payments are already prohibited under Brazilian law.⁷³ This did not assuage KLP's concerns that the anti-corruption program appears focused almost exclusively on the risk of corruption in Brazil, rather than in subsidiaries abroad as well.

Lastly, Petrobras supports the Extractive Industries Transparency Initiative,⁷⁴ but does not report publicly on payments to host governments in a country-by-country format. Rather, the company reports on payments made in Brazil versus payments "abroad".⁷⁵

5. Dialogue with Petrobras

KLP sent a draft copy of this decision to Petrobras for review.⁷⁶ In general, the company pointed to the variety of anti-corruption initiatives undertaken in response to the investigation as evidence that Petrobras takes corruption seriously. Petrobras representatives underlined that the company is cooperating with the relevant authorities and that it is making all efforts to recover bribes paid from the individuals involved.⁷⁷ In the Brazilian criminal investigation, Petrobras is considered a victim of corruption. As for the ongoing internal investigations, Petrobras was not in a position to provide more details on their mandates, or to confirm whether the results of these investigations would be made public.⁷⁸

6. Analysis

According to the KLP Guidelines for Responsible Investment, "KLP shall exclude companies from investment where there is an unacceptable risk that the company is responsible for or complicit in...gross corruption...."⁷⁹ There are two main elements to this criterion: (1) whether the company has been or is currently involved in gross corruption; and (2) whether there is an unacceptable risk that such conduct is ongoing or will occur again in the future.

D. Gross corruption

KLP uses the same definition of "gross corruption" as the Council on Ethics for the Norwegian Government Pension Fund – Global. This standard derives from Norwegian law and international conventions:⁸⁰

Gross corruption exists if a company, through its representatives,

a) gives or offers an advantage – or attempts to do so – in order to unduly influence:

i) a public official in the performance of public duties or in decisions that may confer an advantage on the company; or

⁷³ Ibid.

⁷⁴ EITI, *Petrobras*, <https://eiti.org/supporters/companies/petrobras> (last visited 11 April 2016).

⁷⁵ Petrobras, *Costs and taxes*, <http://www.investidorpetrobras.com.br/en/operational-highlights/costs-and-taxes> (last visited 11 April 2016).

⁷⁶ Notes on file with KLP.

⁷⁷ Ibid.

⁷⁸ Ibid.

⁷⁹ KLP, *The KLP Guidelines for Responsible Investment* (last updated November 4th, 2014). URL: http://english.klp.no/polopoly_fs/1.33317.1459346158!/menu/standard/file/KLP%20guidelines%20for%20responsible%20investment%20-.pdf.

⁸⁰ Council on Ethics, *Recommendation of 15 November 2007*, p. 4. URL: https://www.regjeringen.no/globalassets/upload/fin/statens-pensjonsfond/recommendation_on_siemens.pdf.

ii) a person in the private sector who makes decisions or exerts influence over decisions that may confer an advantage on the company,

and

b) the corrupt practices as mentioned under letter a) are carried out in a systematic or extensive way.⁸¹

Turning to the first element, testimony given to Brazilian authorities thus far depicts a standard practice of inflating contracts between Petrobras and suppliers by three percent of the contract value,⁸² with the excess funneled to Brazilian political parties and politicians, as well as senior representatives of Petrobras. According to the company's audited financial statements, Petrobras paid at least US \$2 billion in "improper payments" between 2004 and 2012.⁸³

Petrobras argues that the company is the victim of corruption at the hands of senior officials, as the payments did not confer an advantage on the company. While it is true that the suppliers were the immediate beneficiaries, as the bribes enabled them to obtain lucrative contracts with Petrobras, this does not mean that Petrobras failed to obtain a benefit from the arrangement. The Brazilian investigation has unearthed evidence of complicity in this scheme among senior managers at Petrobras, who themselves benefited through various kickbacks and were therefore well acquainted with the practice. The inflated contract payments effectively made Petrobras the benefactor of ill-gotten gains for a variety of Brazilian officials. The bribe amounts received by Brazilian lawmakers were not trivial, and it requires no stretch of the imagination to assume these payments unduly influenced the recipients to confer an advantage on Petrobras – legislative or otherwise.

On a broader point, companies act through their representatives. In this case, senior executives at Petrobras were involved in illegal activity over a period of nearly a decade. During this time, over two billion USD disappeared from the company through inflated contracts with suppliers, with the proceeds paid to senior Petrobras executives, political officials, and political parties. It is difficult to see how such a substantial sum could escape the routine control mechanisms of a multinational oil and gas company without the involvement of multiple individuals throughout the firm.

In relation to the second element of the "gross corruption" definition, there is no doubt that the practices at issue occurred in a systematic and extensive way.

E. Forward-looking or ongoing risk

In addition to the above analysis, KLP evaluates whether there is an unacceptable risk that a portfolio company will be responsible for gross corruption in the future. For corruption cases, this is usually the most challenging part of the analysis, as corruption is illegal in most jurisdictions. As a result, companies typically respond to credible allegations of serious corruption by implementing measures to reduce future risk, doubtless partly in an effort to reduce any potential sanctions from government authorities.

i. Extrinsic factors – opportunities for corruption

⁸¹ Ibid, p. 3-4.

⁸² Petrobras, *Check out the publication of our audited financial statements* (15 April 2015), <http://www.petrobras.com.br/en/news/check-out-the-publication-of-our-audited-financial-statements.htm> (last visited 1 April 2016).

⁸³ Ibid.

Extrinsic factors that affect the risk for future corruption include both the company's exposure to opportunities for future corruption as well as the threat of detection and punishment. The industry and jurisdictions in which a company operates can also be indicative in this regard.

Industry and geographic exposure

The oil and gas sector is among the most high-risk industries for corruption.⁸⁴ The main sources of risk include local requirements to enter joint ventures with state-owned enterprises as well as multibillion-dollar procurement contracts and licenses.⁸⁵ Moreover, Petrobras operates in several countries that score among the lowest on the Transparency International Corruption Perceptions Index, including Angola, (163), Venezuela (158), and Nigeria (136).⁸⁶ Hence, the industry and geographic risk for future corruption is high.

Media coverage

The Petrobras corruption scandal continues to attract significant press coverage both within Brazil and abroad. The intense media scrutiny will almost certainly have a preventative impact, at least with respect to Petrobras' activities in Brazil. Nevertheless, KLP is concerned that Petrobras has not announced plans to undertake a thorough review of the corruption risk in its operations outside of Brazil. The anti-corruption measures Petrobras has implemented thus far also appear focused primarily on the company's activities in Brazil. Given that the company adopted comprehensive anti-corruption guidelines first in 2013, an investigation of potential corruption in Petrobras' foreign operations appears warranted.

Law enforcement

On the enforcement side, the Brazilian police and prosecutors have thus far shown no hesitation in pursuing corruption allegations involving a broad swathe of highly placed Brazilian politicians and businesspeople. Sitting members of parliament are shielded from prosecution while in office to a certain extent, however, as their case may only be heard by the Supreme Court. As a result, evidence regarding bribe recipients may unfold somewhat slowly. Based on the investigation thus far, the Brazilian justice system is aggressively pursuing the case. This will almost certainly have a preventive effect in the future. At the same time, this type of aggressive prosecution of the rich and powerful is unprecedented in Brazil. There is no shortage of politically well-connected individuals with a vested interest in obstructing the investigation, however. It is not unthinkable that a change in the political constellations in Brazil might render the investigation more vulnerable to this type of pressure.

ii. Intrinsic factors – anti-corruption preparedness

The Petrobras anti-corruption program includes the majority of the elements generally assumed to be a part of a comprehensive anti-corruption program. The failure to prohibit facilitation payments is a weakness, however – particularly as the company explains the omission with reference to Brazilian law. KLP remains concerned that the company's anti-corruption programs appear designed without sufficient concern for the risk of corruption in Petrobras's operations outside of Brazil. Petrobras

⁸⁴ Guy Chazan, "Oil and gas has highest bribery rate", *Financial Times* (15 July 2012). URL: <http://www.ft.com/intl/cms/s/0/c84ead24-ce7e-11e1-bc0c-00144feabdc0.html> (last visited 12 April 2016)..

⁸⁵ *Ibid.*

⁸⁶ Petrobras, *Global presence*, <http://www.petrobras.com/en/about-us/global-presence/> (last visited 11 April 2016); and Transparency International, *Corruption Perceptions Index 2015*, <http://www.transparency.org/cpi2015> (last visited 11 April 2016).

maintains that it has disciplined those responsible for corruption – presumably, those that have not already been convicted – but, the details are not forthcoming at this point.

The more vexing problem for Petrobras will be addressing the corporate culture in a company where the disappearance of over USD 2 billion in inflated contracts can occur without raising any red flags internally – at least none that appear to have risen to the CEO or board level. In this respect, the intertwined relationship between the company, the majority shareholder, and the largest political parties in Brazil gives KLP as a minority investor cause for concern. The current governance structure also limits the ability for minority shareholders to press for change, as the Brazilian state controls 70% of current board seats.

Petrobras also continues to maintain that it is a victim of corruption.⁸⁷ This is correct in terms of the company's status in the criminal proceedings under Brazilian law, but misses the broader point. Corruption of the scale and scope uncovered at Petrobras could not occur without the involvement and, at a minimum, tacit acceptance of employees at various levels of the company. Senior Petrobras representatives have been convicted for their role in the corruption scheme. In this context, Petrobras's insistence that it is a victim of corruption suggests an attempt to evade responsibility. In KLP's experience, the companies that are most successful in making a clear break from past incidences of corruption are those that are willing to cast a broad net in scrutinizing all potential weaknesses and to address transparently the additional skeletons that are almost inevitably unearthed. It is difficult to take such an unflinching stance while simultaneously claiming status as a victim.

In this vein, KLP remains concerned that Petrobras does not appear to be engaging in any broader investigation of corruption outside of Brazil. Given the weak controls uncovered – at least prior to the adoption of anti-corruption guidelines in 2013 – as well as the company's industry and geographic exposure, the absence of a broader investigation appears misguided.

As a means of reducing the risk of future corruption, KLP recommends Petrobras take the following actions:

- Engage in a broader investigation of corruption risk in all markets in which the company operates and develop measures to minimize the risks uncovered
- Develop a robust and company-specific training for all employees, available in all relevant languages
- Conduct an integrity due diligence of current suppliers, prioritized by risk and importance to Petrobras in terms of contract size and duration
- Obtain external assurance of the new compliance program
- Implement appropriate disciplinary measures for employees who have been involved in or neglected to report instances of corruption
- Ensure that both the board and top management include individuals with expertise in anti-corruption
- Develop a culture in which raising concerns about ethical issues is not only accepted, but required
- Ensure the tone from the top and Petrobras's actions are consistent with the company's anti-corruption commitments

For all of the above reasons, KLP considers continued investment in Petrobras to constitute an unacceptable risk of association to corruption.

⁸⁷ Call notes on file with KLP.

7. Decision

KLP and the KLP mutual funds exclude Petrobras from their investments at the latest 1 June 2016.